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A RESPONSIBLE ECONOMIC PACKAGE

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Economic policy decisions are an on-going function but occasionally a watershed situation develops and society must decide the course of the economic system far into the future. We are in such a situation today. We have an opportunity to break the vicious inflationary pressures which have disrupted our economy--which even threaten our entire society--but we must also minimize the human and institutional pains of the necessary transition back to more stable prices. In planning for the future we must be sensitive to current difficulties. But continued procrastination in taking the necessary actions to restore economic stability will only make the adjustment process more difficult and painful. The American people deserve leadership that will correctly identify the problems and then provide a responsible package of economic policies to achieve our long-term goals.

If constructive decisions are to be made, there must be increased cooperation between Congress and the Administration. If Congress is to have the necessary motivation to cooperate with the Administration, it will require universal support of the general public. That is the purpose of trying to communicate to the American people the importance of pursuing responsible economic policies.

At the present time there is a feeling of great uncertainty and apprehension. This feeling is caused by the many real economic pressures we are experiencing and the confusion created by a number of economic myths that have developed over the years. In a fundamental sense these economic myths are complicating our efforts to develop responsible economic policies that will be recognized and supported by the general public. Before we can develop a viable policy we must destroy these economic myths. I am convinced that if the American people understand the real problems and have confidence in their institutions, then this Nation can overcome the current difficulties. A responsible set of policies will enable us to avoid the incessant demands that the government "do something" such as turning to a proposed spending and monetary stimulus which would only lead to even greater inflation, unemployment and eventually a controlled economy.

Myth Number 1: "We don't know how we got here!"

One often hears that this is a new world in economics. Or, that we don't understand what has happened to us. Americans are used to surpluses—not shortages; to strong output gains--not sluggish performance; to moderate inflation—not a double-digit pace. I would argue that the claim that some new force has created our problems is a false concept. Careful analysts can identify the policies and events that have created "stagflation." Understanding the reasons for our current inflation and sluggish output is the necessary beginning for developing a remedial program. Even more important, such understanding is a crucial ingredient in restoring confidence in our institutions. The American public must be convinced that the Administration and Congress are on top of the situation and acting decisively. The clear challenge of economic leadership is to restore that public confidence.

The first reason we have inflation is that we have spent too much. For many years we have naively believed that our government could identify, solve and pay for all of the problems of society—right now. If it required 300 years to build 60 million units of housing, why not add 26 million units in a single decade? If it required several decades to first create and then destroy the world's greatest transportation system, why not replace it in a decade with mass transit? Why not have a program for every problem since there was always the comforting illusion that someone else—"they"—would pay for it. This false expectation has gotten us more government than we want, more than we need and obviously more than we are willing to pay for.

In Fiscal Year 1966, the Federal budget totaled \$134 billion. Eight years later it had doubled to a level of \$268 billion. In the current Fiscal Year 1975 we will spend over \$300 billion. This unfortunate pattern of rapidly increasing outlays has created a long series of Federal deficits. In Fiscal Year 1975 another sizable gap will be reported making our record a dismal 14 deficits during the past 15 years. When the Federal Government runs a deficit, the Treasury must go into the capital markets, at the very head of the line, to raise the necessary funds to finance those deficits. Where does that leave the business borrower, the personal borrower and the mortage borrower?

Obviously, they must be at the end of the line. Yet these reported Federal deficits are only the beginning of the story because they do not include the "off-budget" needs of Federally-supported lending programs that add billions of dollars to the total financing requirements. When Federal needs usurp the capital funds available the entire system is disrupted. Eventually the housing market cracks. Personal consumption declines. Business investment falters and jobs are lost. International obligations are disrupted. Ultimately, the system breaks down because capital is not available. We have had a surge of governmental spending at a rate which goes far beyond either our willingness or ability to pay for.

The second reason underlying the current inflation is the past decade of excessive monetary stimulus. Over the past three years the money supply has expanded at an average annual rate of approximately 7 percent. In 1972 the money supply increased 8.4 percent. If the rate of monetary expansion in 1972 was approximately double the long-term growth target for the economy, is there any reason for surprise when inflation and shortages occurred in 1974? It is true that the growth of the money supply in 1973 was held to the Fed's stated goal of 6 percent, but over an extended period of time—for at least a decade—the Federal Reserve System has been called upon to finance the excessive spending levels of the Federal Government. As a result, monetary stimulus has gone far beyond the sustainable growth level that we need to support stable economic growth.

The third reason for our current inflation is that we have been unwilling and unable to eliminate the hundreds of governmental policies which inhibit the efficiency and effectiveness of our economic system. Basic common sense—certainly the beginning course in economics—tells us that unless we use our resources efficiently, we will either produce fewer goods and services with those same resources, or we will have to devote still more valuable resources to produce the same volume of goods and services. The Federal Government has unnecessarily restricted the operation of our entire economic system. This policy of waste and restriction might have been tolerable for another time—perhaps the 1930's when economic stagnation existed—but in today's world, even in a country as affluent, as creative and as productive as America, we clearly cannot continue to waste our valuable human and material resources. We need

to stimulate competition and innovation rather than artifically protecting the status quo. This process should include the development of dynamic new industries to replace those which have become obsolete or noncompetitive in an integrated world economy. This more aggressive approach will create jobs, not destroy them. It will moderate price pressures. It will improve the use of available capital resources. Best of all, it will make our entire system more efficient in contributing to the welfare of all 213 million Americans.

The fourth reason we are in our current position is that we have had an unprecedented series of crop difficulties in 1972, 1973, and again in the 1974 harvest. We have been hard hit by a series of international and national difficulties, which have combined to create serious worldwide food shortages. The Rome World Food Conference was originally planned to discuss the long-term future of agriculture. Instead, the meeting was dominated by discussions of the current famine. The shortages of food have had a particularly serious impact on inflation. In 1973, retail food price increases accounted for over 50 percent of the increase in the consumer price index. Food prices at the wholesale level continue to increase which suggests that we will probably continue to have very serious food price problems.

Fifth, we have experienced an unreasonable and largely unexpected quadrupling of prices of crude petroleum. The average American recognizes the impact of this change on gasoline and home heating fuel prices but we often ignore the pervasive effects on chemicals, plastics, transportation, man-made fibers, petrochemicals, etc.

The sixth reason for our current inflation involves the international overlapping of demand in 1972 and 1973 which occurred when most industrialized nations overheated their economies at the same time. As a result, many industrialized countries were chasing the same raw materials and the same markets creating excessive output pressures and accompanying inflation.

Seventh, we are now suffering from the accumulated distortions of three years of wage and price controls. Such controls are most unfortunate because they create shortages and distort the proper operation of an economy such as ours which depends upon flexible price and wage adjustments to allocate

resources. In specific terms such controls divert capital investment, create artificial motivations for exports, disrupt competitive relations and in general reduce economic efficiency. In addition, they don't work. The inflation figures for the past three years and the record of World War II and Korean War experiences all indicate that artificial restrictions cannot stop the underlying wage and price pressures.

It is clear that there are at least seven major variables that have contributed to the present level of unacceptable inflation. The myth that we don't know how we got here is false. Too much monetary stimulus, too much Federal, State and local government spending, our unwillingness to attack governmental policies which inhibit economic efficiency, the food shortages of recent years, the quadrupling of petroleum prices, the international overlapping of demand, and the accumulated distortions caused by wage and price controlls--all of these forces have contributed to our present problem.

Myth Number 2: "We don't know how to get out of here!"

This myth is just as false as the first one but it is as equally widespread and accepted by the general public. Once we recognize the sources of our difficulty, we can begin to develop a program for improvement. The program begins by identifying the correct goals. Some people argue that our current inflation is simply the result of a classic cyclical overheating caused by excessive monetary and fiscal stimulus in recent years. If this were only a cyclical overheating, all one would have to do is reverse these policies and then wait long enough for the excesses of the past to be worked out through the system. But our problems are far more complicated than those caused only by fiscal and monetary mistakes.

Others would claim that inflation is the convergence of many years of mandated legislative programs which have created excessive demand. The simple response to this type of problem would be to arbitrarily eliminate numerous government programs. But this simplistic explanation would not be an adequate solution either.

A third explanation for our inflation is that a series of unexpected aberrations—such as rapid price increases for food, petroleum and raw materials—can be blamed for our current problems. The best approach to this set of problems would be to encourage maximum farm output, an aggressive energy policy and an unravelling of the recent demand pressures for raw materials. Unfortunately, inflation would persist even if all of these things occurred.

The blunt fact is that there is no single explantion for our inflation. In fact, any one of the seven factors described would have caused a serious inflation problem. The convergence of all of these problems in recent months has created the intolerable inflation we are now experiencing. Understanding the multiple causes of inflation is the necessary beginning for creating a responsible program to achieve multiple goals.

As to the second myth that we do not know how to get out of here, the President announced a balanced package of economic actions last October 8. The strength of his program is that it will not concentrate on any one of these single problems but it will focus on all of our objectives. It also correctly identifies inflation as the Nation's number one economic problem. This priority reflects the terrible impact of inflation on all of the other problems of unemployment, inadequate capital investment, sluggish output and international instability.

Our first policy goal is to sustain responsible fiscal policies. People often ask me why the Administration wants to cut spending when current output is already below the normal target of a 4 percent annual growth in the "real" GNP. My response is that the Federal budget is not being cut. To the contrary, Fiscal Year 1975 outlays will represent a massive increase in the Federal budget. An increase in the Federal budget from $268 billion in Fiscal Year 1974 to $302 billion this fiscal year, which is the President's target, hardly represents an incensitive policy. In reality the Federal budget will report at least a $34 billion increase, a gain of 12.6 percent in a single year. The original spending target for Fiscal Year 1975 of $305.4 billion would have resulted in a 13.8 percent increase in Federal spending this fiscal

year. These rates of spending increases should be compared to the overall performance of the economy which has risen only 7.8 percent over the past four quarters measured in inflated dollar terms and which has recorded a decline of 2.3 percent in the "real" GNP during the same period.

The Administration, far from trying to cut the Federal budget, is actually trying to restore control over the upward momentum of Federal outlays. Last summer it became clear that Federal spending was rapidly rising to a prospective level of $312 or $315 billion. Back in fiscal years 1966, 1967, and 1968 when the Federal budget increased rapidly and inflation began to accelerate, the annual increases in spending rose 13.8, 17.5 and 13.0 percent respectively. The challenge of regaining budgetary control is of crucial importance to our current anti-inflation efforts. Even more important, we must regain fiscal discipline if we are to control our future economic destiny. If the Administration and the Congress do cooperate to hold down spending in the zone of $302 billion, the first step towards progress in re-establishing fiscal discipline would result.

Some critics have argued that a possible reduction of $4.6 billion in Federal outlays as the President requested in his submission of budget recisions and deferrals for Congressional consideration represents only a meaningless gesture in a massive $1.4 trillion economy or even in a $305 billion Federal budget. I recognize that a reduction of approximately $5 billion from such a large budget would represent only a 1½ percent cut in spending. But such action is an important test of our credibility and the strength of our resolve to regain control. Furthermore, a cut of 1½ percent would hardly be a devastating blow to most government agencies and programs. I fully recognize that existing legislative requirements would preclude any reduction in some programs but we also know that administrative and operational fat exists in almost any process or organization.

Others claim that a difference of $5 billion of spending in the Federal budget would result in a reduction of only one-tenth of one percent from the expected rate of inflation. Even if that is the econometric result, and I am frankly very skeptical of the estimate, that is not the point.

The spending level in Fiscal Year 1975 will determine the outlays in Fiscal Year 1976 and far out into the future. The real impact of fiscal responsibility now will be to moderate the rate of future inflation. Unfortunately, most people ignore the cumulative pressures created by current outlays. The blunt fact is that our society is living off the production of the past and we are spending the seed corn needed for capital investment in the future.

Unless we regain control of the Federal budget, the momentum of current spending will carry us to totally unacceptable future levels of spending. Unless we face up to this issue in Fiscal Year 1975 and again in Fiscal Year 1976, we could well be confronted with a $400 billion budget in Fiscal Year 1977 which is only fourteen years after we first exceeded the $100 billion level in Fiscal Year 1963.

The second component of a comprehensive set of responsible policies is to sustain a monetary policy that will result in a more moderate growth in the money supply, supporting economic growth but not creating excessive stimulus. It is true that the money supply growth figures were very low during the late summer. But if we have learned anything about monetary policy, it should be that the monetary measures should not be judged on the basis of only a few months of figures. To properly evaluate monetary policy it is necessary to examine at least a six to twelve month span of time. A longer-term review indicates that the Fed's policy is directed at several objectives, including an annual rate of expansion in the money supply of approximately 5 to 6 percent. In 1973 the money supply did increase 6 percent. The current targets also appear to be in that general zone. Recent policy actions by the Fed suggest a desire to accomodate credit needs during this difficult period but there should not be any massive shift to monetary stimulus which would prematurely dilute the current anti-inflation pressures that are now beginning to accumulate.

Critics continue to claim that monetary policy must be strangling economic activity because interest rates are at historically high levels. The general public often naively assumes that the Federal Government arbitrarily sets interest rates. Anyone familiar with the dynamic demand and supply pressures in our financial markets recongizes the erroneous nature of that

viewpoint. There should be no doubt that the high interest rates reflect the intolerable effects of double-digit inflation because creditors must obviously add a premium to the real cost of the funds they lend if they are to avoid negative interest rates. When we suffer from double-digit inflation we will obviously have double-digit interest rates.

If the money supply is increased at a normal rate of 5 to 6 percent, and if an additional expansion of 2 to 3 percent results from increased velocity, this combination will support an 8 to 9 percent growth rate in the Nation's GNP. This type of monetary policy will not support a double-digit rate of GNP growth which would result mainly from exorbitant price increases. When people say that a 5 to 6 percent growth rate for the money supply will not support the kind of double-digit inflation that now afflicts our economy, my response is to agree. Monetary policy is supposed to bite; but it is not intended to be severely restrictive policy. It is supposed to bring down gradually the excessive rate of inflation.

Unfortunately, the Fed has had to bear a disproportionate share of the anti-inflation program. No one likes high interest rates. I do not. We certainly do not want mortage interest rates to be at a level that curtails housing activity. But it should be obvious that the only way to get interest rates down is to gradually moderate the rate of inflation so that prospective lenders can reduce the premiums which must be added to cover the anticipated rate of inflation.

Our <u>third policy</u> involves an attack on government policies which waste our human and material resources through artificial controls and inefficiency. A few weeks ago, I became so tired of hearing people say: "Why don't you do something?" that I decided to analyze governmental programs. A member of my staff met with senior officials of many government agencies to solicit their ideas. He reviewed the reports and studies of many years concerning government programs. He then catalogued every recommendation made in the various economic summit meetings. The results of all this analysis were summarized in a long policy memorandum. That memorandum included 86 specific policy recommendations for <u>immediate</u> action. The President's package of economic policies presented on October 8th included many of those

suggestions. But there were also over 200 additional suggestions for future action.

My point is that there are many specific actions that could be taken to reduce the disruptive impact of undesirable governmental programs. It is clearly not a problem of not knowing what to do. The difficulty comes in getting real action in correcting existing abuses. This is the dilemma of public service. If the general public is asked to support the removal of some government restriction the typical reaction of 213 million American is apathetic at best. Most people cannot relate the effects of government regulation to their own lives. A classic example is the lack of public support for the current Surface Transportation Act which would provide a modest start for some badly needed deregulation of the railroads. But while the general public usually has little response the specific group threatened by change usually mounts a massive campaign to protect its own interests. A strong and vociferous minority usually wins when an apathetic majority fails to react. Attempts to move ahead on deregulation, increasing productivity, reduction of special interest benefits, etc. is often frustrated by the combined efforts of three powerful groups: (1) the special interest groups that receive current benefits; (2) a Congressional Committee with "oversight" responsibilities; and (3) an Executive Department responsible for running the program. It is extremely difficult to overcome this combined opposition but the blunt fact is that unless we do, we are going to keep wasting very valuable human and material resources which will add to inflation.

Our fourth policy focuses on achieving maximum output of food. It can be simply stated: All-out production. After 40 years of curtailing agriculture production through artifical restrictions, new farm legislation was finally passed last year which now emphasizes production. Millions of acres which were previously set aside to curtail output have now been returned to production. Other restrictive practices which inhibit the efficient production and distribution of agriculture will be removed.

The fifth policy area concerns energy actions. The energy crisis has been developing since at least 1970 but we ignored it until last fall's oil embargo and the sharp jump in gasoline prices. There are basically two

energy policy options: to expand efforts to conserve energy and to accelerate development of domestic resources. We must move ahead rapidly on both options. On the conservation side, we have found that businesses can reduce their energy requirements by 20 to 25 percent. Gasoline consumption has been reduced by voluntary efforts and some heating fuel consumption has been cut. The experiences of 1974 have demonstrated that conservation of energy is possible--and that it is good economics for consumers and businessmen. For 1975, the President has announced a goal of reducing this Nation's anticipated petroleum imports by 1 million barrels per day. The President will soon announce a comprehensive energy program. This set of policies will emphasize voluntary energy conservation measures--but there are mandatory alternatives if the voluntary programs will not work.

As to the development of additional energy resources, we need to turn to the immediate use of available technology and known energy reserves. In terms of meeting our oil needs we already know about Alaska's North Slope reserves, off-shore drilling, oil shale deposits, improved recovery from existing producing wells and accelerated exploration efforts. We are not helpless. But we need to act. And we need to act forcefully in developing our domestic petroleum resources.

We also should give increased attention to our coal resources which far exceed the oil holdings of the current oil producing countries. We will still have massive coal reserves long after the oil resources of some of the major producing nations are exhausted. But we must develop our coal reserves <u>now</u> in order to remain independent from any future energy embargo. We need to move ahead with the necessary technology for the mining and utilization of coal in ways which will be consistent with environmental and safety standards.

We also need to accelerate the development of our nuclear energy facilities. About a decade ago, it was estimated that nuclear energy facilities would provide 25 percent of the Nation's electrical energy by the 1970's. We have fallen far short of that goal. Within a 100-mile radius of Washington, D.C., there are six nuclear energy facilities under construction which are only 60 to 85 percent completed because of financing

and regulatory problems. Completion of these and similar facilities in other States could make a major contribution toward achieving the Presidential goal of reducing oil imports.

A final area of concern involves the problems created for specific sectors of the economy by the sluggish pace of current output. Unemployment is the unwanted result of this economic slowdown and special attention must be given to these "casualties" of economic stagflation. The President's program attempts to provide this special consideration by supporting programs to aid housing, provide tax relief for low-income families, extend unemployment benefits and create an effective public employment program to offset unemployment gains over the coming months.

These so-called "safety net" programs are an attempt to give specific help rather than simply increase general government spending and expand the money supply. If the country is to have the flexibility needed to sustain responsible fiscal and monetary policies for a sustained period of time, policies must be sensitive to those people and institutions in society which are hurt by stagflation.

Myth Number 3: "Now is the right time for massive economic stimulus."

At this particular stage of the business cycle it is customary to sharply increase fiscal and monetary stimulus in the hope that the resulting spending will somehow "trickle down" to the unemployment casualties of the current economic slowdown. The Government usually makes this mistake when unemployment begins to rise and the "real GNP' declines. There is a common view among some government officials and economists that the Federal budget is an effective short-term economic stabilization tool. To the contrary, the Federal budget should focus on the long-term allocation of resources and the mix of public and private-sector responsibilities. When the Federal budget is used as a short-term stabilization tool, its real long-term function is disrupted and the short-term results are disappointing.

The "trickle down" approach doesn't work because of the time lags involved. It takes one to two years for most new government spending programs to directly influence outlays in the system. The long time lags result in the government stimuli arriving too late to alleviate the economic slowdown but in time to exaggerate the subsequent boom and inflation. Here is the impact of monetary stimulus immediate, although the impact is not as delayed as is fiscal stimulus.

A second problem with the "trickle down" approach is that there is too much leakage over time because this approach is too blunt to accomplish the specific goals desired. A superior approach is to identify and act on specific programs. particularly for unemployment and housing needs.

Myth Number 4: "Inflation is our only problem!"

The fourth myth is that government economic policies can focus entirely on inflation. One often hears, correctly, that inflation is Public Enemy No. 1. But we must recognize that inflation is not any more evil or socially undesirable than unemployment, lost capital investment or international economic distortions. Inflation is not the number one problem because it is somehow more evil. Inflation is currently the major concern because unless we get control of inflation, we will have even worse unemployment, more disruptions of needed capital investments and increased international economic tenions.

Inflation is disrupting the housing industry. It is inflation which is disrupting business investment. Inflation is the fundamental factor in disrupting the world's economic stability. Therefore, inflation is the number one economic problem because it is the major factor causing the other difficulties. This extreme influence is caused by the remarkable double-digit nature of our price indexes. We can no longer talk about the traditional economic tradeoffs until inflation is significantly reduced. We cannot expect other problems to improve until control of inflation is achieved.

<u>Myth Number 5: "We have a policy which will achieve quick and painless results!"</u>

Let me conclude with my fifth myth: that there is some unique solution that will provide a quick and painless solution. Such rhetoric is usually heard from political candidates and government apologists, so we can expect to have some moderation in such claims over the coming months. But it should be emphasized that it is a myth that there is an easy solution; that we can complete the difficult adjustment quickly; or that the adjustment process will be painless. It will not be easy. It will not be quick. And it is certainly not going to be painless.

As I look back over my experiences in finance as well as in government service, I now have even more confidence in the effectiveness of monetary and fiscal policies if they are responsible, consistent and sustained. The only basic change in my economic expectations has been to stretch out the time duration of the adjustment process. The current problems are the results of many years of irresponsible policies and, therefore, it will take time to correct them. We all must realize that there are no quick and easy solutions. This is not to be interpreted as a message of gloom. I think it is a challenging message. These problems are not insurmountable but we must first of all do away with several economic myths. Most of all, we must sustain the adjustment process until we regain control of our economy.

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